(24)

No. 92-1384

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC,
Petitioner,

vs.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

BRIEF FOR PETITIONER

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QUESTIONS PRESENTED

1. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the foreign Commerce Clause.

2. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, intrudes into an inherently federal area and is preempted by the United States Constitution.

3. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the Commerce Clause where such application imposes discriminatory compliance burdens on such entities.

4. Whether California's system for compliance with worldwide combined reporting violates the Due Process Clause of the United States Constitution where compliance is not possible without undue cost and the system, to function, depends on discretionary relief provisions without constitutionally sufficient standards to guide application and prevent arbitrary enforcement.

LIST OF PARTIES

The parties are as stated in the caption. In the courts below, the plaintiffs and respondents were Barclays Bank International Limited ("BBI"), a United Kingdom corporation, and Barclays Bank of California ("Barcal"), a California corporation which was wholly owned by Barclays Bank International Limited. BBI was merged with Barclays Bank PLC and Barcal was sold to Wells Fargo & Company, with the present tax matters and claims for refund being assumed by Barclays Bank PLC.*

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*Pursuant to Rule 29.1 of the Rules of this Court, Petitioner states that during the income year 1977, BBI was a wholly owned subsidiary of Barclays Bank Limited ("BBL"), also a United Kingdom corporation. During income year 1977, Barcal, a domestic corporation, was a wholly owned subsidiary of BBI. On February 15, 1982, BBL reregistered as a public company under the provisions of the Companies Act 1980 of the United Kingdom and changed its name to Barclays Bank PLC. On January 1, 1985, under the terms of the Barclays Bank Act 1984 of the United Kingdom, the United Kingdom banking business of Barclays Bank PLC was merged with the international and other overseas banking operations of BBI under the name Barclays Bank PLC. The ultimate parent of Barclays Bank PLC is now Barclays PLC, listed on the London Stock Exchange. On February 20, 1988, Barclays Bank PLC sold the stock of Barcal to Wells Fargo & Company. Under the terms of the agreement, Barclays Bank PLC assumed any tax liability at issue herein and retained all claims for refund. Barclays Bank PLC's non-wholly owned subsidiaries are listed in Appendix I to this brief.

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OPINIONS BELOW

The Statement of Decision of the California Superior Court (Appendix A to the petition for certiorari)[1] is an unreported decision. The first opinion of the Court of Appeal of the State of

[1]All references to the appendices to the petition for certiorari are denominated "PA" followed by the letter of each appendix and, where necessary, a page reference. References to other materials are as follows: (i) appendices to the petitioner's supplemental briefs are "PSA(1) or (2)" followed by the letter of each appendix; (ii) Joint Appendix references are "JA"; (iii) testimony not reproduced in the Joint Appendix is cited as "R" followed by page number; and (iv) trial exhibits not reproduced in the Joint Appendix are cited as "Ex."

California in and for the Third Appellate District (PA B) was reported at 232 Cal. App. 3d 1187 (1990) and again at 3 Cal. App. 4th 1034 (1990) to permit tracking of the case pending review by the California Supreme Court.[2] The opinion of the Supreme Court of California (PA C) is reported at 2 Cal. 4th 708 (1992). The opinion of the Court of Appeal on remand, as modified, is reported at 10 Cal. App. 4th 1742 (1992) (PA D). The California Supreme Court denied further review on February 18, 1993 without opinion (PA E).

JURISDICTION

The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1257(a). The California Supreme Court's May 11, 1992 opinion (PA C) decided the first question presented but remanded the cause to the California Court of Appeal for consideration of the remaining federal issues. The California Court of Appeal issued a judgment upon remand and the California Supreme Court denied a timely filed petition for review on February 18, 1993. Petitioner filed a petition for writ of certiorari on February 22, 1993, which this Court granted on November 1, 1993.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The constitutional, statutory and regulatory provisions involved are: Article I, Section 8, Clause 3 of the United States Constitution (the Commerce Clause); Article VI, Clause 2 of the United States Constitution (the Supremacy Clause); Amendment XIV, Section 1 of the United States Constitution (the Due Process Clause); California Revenue & Taxation Code Sections 25101 and 25137; and California Code of Regulations, Title 18, § 25137-6. The texts of the constitutional and statutory provisions are set forth in PA F. The text of the regulation is reproduced in PA J.

[2]Pursuant to the California Rules of Court, Rule 976(d), the opinion of the Court of Appeal was vacated by the Supreme Court of California's grant of review on February 28, 1991.

STATEMENT

The issues raised by this case — issues specifically reserved by this Court in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983) — concern the powers of a state to tax a domestic corporation with a foreign parent, or a foreign corporation with either a foreign parent or foreign subsidiaries, under worldwide combined reporting. The precise question presented is whether California's application of worldwide combined reporting to Barcal, a domestic corporation with a foreign parent, and to BBI, a foreign corporation with a foreign parent and foreign subsidiaries, is unconstitutional.

California's method of taxation already has caused serious national and international repercussions. The United States appeared as amicus curiae in the courts below to assert that this method is "patently unconstitutional", PA H-25 n.13, and created interference in the United States' conduct of its foreign economic policy.[3]

1. THE BUSINESS OF THE BARCLAYS GROUP.

In 1977 Barcal and BBI, the California taxpayers, were part of the Barclays Group, a United Kingdom banking group of over 220 corporations doing business in some 60 nations. PA A-23. BBI and BBL agreed for purposes of the litigation that they were members of a worldwide unitary business for 1977. JA-16. The ultimate parent, BBL (now Barclays Bank PLC), was one of the United Kingdom clearing banks. JA-10. Only two corporations in the Group (Barcal and Barclays Bank of New York) were incorporated in the United States and only one other corporation in the Group, BBI, also did business in the United States. JA-10. The Barclays Group conducted over ninety-eight percent (98%) of its business outside the United States. PA A-23. The Barclays

[3]The United States appeared as amicus curiae in the California Superior Court, Court of Appeal and Supreme Court (PA H) and in this Court in support of Barclays' first petition for certiorari (PSA(1) K). The United States opposed grant of Barclays' second petition for certiorari. U.S. Am. Br., No. 92-1384. *See* Part 6 of the Statement, *infra*.

Group was and is involved in all phases of international banking, including retail, merchant, and commercial banking, leasing and consumer credit and finance. JA-10 to 11.

BBI was organized under the laws of England and was domiciled and doing business in the United Kingdom. JA-9 to 10. BBI also did business in more than 33 other nations and territories outside the United Kingdom, including the United States. JA-10. BBI operated a banking agency in California. JA-9 to 10. BBI itself owned, directly or indirectly, more than fifty percent (50%) of over 70 subsidiary corporations which also operated in approximately 34 nations and territories outside the United Kingdom. PA A-23; JA-10. Barcal, a California banking corporation, was a wholly owned subsidiary of BBI. JA-11.

2. THE INTERNATIONAL STANDARD FOR DIVISION OF INCOME AMONG NATIONS FOR TAX PURPOSES AS COMPARED TO WORLDWIDE COMBINED REPORTING.

The United States, the United Kingdom and other nations of the world divide the income of multinational enterprises among nations for tax purposes by the arm's length separate accounting method ("the arm's length method"). PA A-20; JA-821, 824. The arm's length method treats each corporation as "an independent entity dealing at arm's length with its affiliated corporations, and subject to taxation only by the jurisdictions in which it operates and only for the income it realizes on its own books." *Container*, 463 U.S. at 185. Where a corporation crosses national boundaries, the host (nondomiciliary) country taxes that corporation only on the profits earned in the host country by that corporation. PA A-20; JA-820 to 21. Profits earned by that corporation in other countries, and profits earned by affiliated corporations in other countries, are not taxed by the host country. PA A-20; JA-824.

The United States has been a leader in establishing the arm's length method as the international standard. R 62 to 64, 1138 to 41. Both the United States and its trading partners use this standard in all bilateral tax treaties and in their internal tax laws. PA A-20; R 212 to 13, 1129 to 31, 1168 to 69; Ex. 37I at 74 to 75.

The standard is "universally used and favored" by the nations of the world both "as an ideal and as a working methodology." PA A-20 to 21; JA-813, 826; Ex. 37C at 33 to 34. The arm's length standard is the custom of nations. PA A-20 to 21; JA-821.

California uses a different and incompatible method to divide the income of a multinational enterprise for tax purposes — worldwide combined reporting (sometimes called the "unitary tax"). PA A-20 to 21; JA-70, 98, 581 to 82; R 65 to 67, 1142, 1146. This method aggregates the income of all entities which form a part of a unitary business, wherever they do business, and determines California's share of this aggregate income by a formula, generally the average of the property, payroll and sales within and without California. PA A-20 to 21. Under this method, the income of all affiliated corporations in the unitary business is included in the California tax base (subject to apportionment), even the income of foreign entities operating solely in foreign countries and doing no business in the United States, let alone in California. PA A-27; *see also* JA-788 to 91. This is true even where most of the corporations in the unitary group are wholly foreign entities. *Id.*

Worldwide combined reporting has as its economic underpinning the assumption that all parts of a multinational business are equally profitable. JA-73; Ex. 37C at 34; Ex. 37I at 77. This assumption fundamentally differs from and is incompatible with the arm's length method which recognizes that costs, values and profits can vary significantly among countries. JA-73 to 74. The income allocated to a tax jurisdiction under the arm's length method can and does differ substantially from the income apportioned to that jurisdiction under worldwide combined reporting. JA-68, 581; Ex. 37D at 3; Ex. 46N. There is no way to reconcile these differences, because the usual means for reconciling disputes (through the reallocation of income from particular transactions) cannot be applied to a system that divides income by formula rather than by transaction. *See* JA-75.

Because the income and factors of all members of the group must be included in the combined report, the California system requires worldwide tax information for all of these companies, not just for those that are California taxpayers. PA A-27. Foreign

multinational enterprises incur greater costs to comply with California's reporting requirements than do domestic multinational enterprises and those domestic enterprises doing business only in the United States. PA A-26 to 27; PA D-9. While domestic enterprises keep most of their records in accord with United States financial and tax accounting principles, foreign enterprises generally have no reason to collect worldwide information in that form except to comply with the California tax system. *Id.* The international standard does not require the reporting of such information. PA A-27. Such foreign enterprises incur significant costs in obtaining the necessary information and transforming it into California tax information. PA A-27 to 28; PA D-9 to 10.

3. THE IMPACT OF CALIFORNIA'S APPLICATION OF WORLDWIDE COMBINED REPORTING TO FOREIGN OWNED MULTINATIONALS.

In the early 1970's, the California Franchise Tax Board first began to apply worldwide combined reporting to foreign owned multinationals. PA A-17. The extension of this conflicting method into the international arena brought immediate complaints from both foreign business and foreign governments. PA A-21; JA-770 to 72, 774; Ex. 37C at 33; Ex. 37I at 78. Foreign governments bombarded the United States government with formal and informal diplomatic protests about worldwide combined reporting as applied to foreign multinationals. Over the years these have included: diplomatic notes from virtually every developed country in the world; protestations directly to the President from heads of nations including Prime Minister Thatcher of the United Kingdom, Prime Minister Nakasone of Japan, and Prime Minister Trudeau of Canada; delay in treaty negotiations by the Netherlands and West Germany; and strong representations from the French, Danish, Italian and German governments. JA-92 to 123, 132 to 140, 600 to 03, 753, 771 to 74, 782; Exs. 32 D, E, F, H, K, N, O; Exs. 32 HH, II, JJ. The Canadian and French tax treaty negotiators insisted on an exchange of notes which called attention to their concerns and which obligated the United States to reopen discussions with each country if an acceptable solution could be devised. JA-477 to 83.

Foreign governments even attempted unprecedented direct persuasion at the state level. JA-779 to 80, 816.

The United States State Department acknowledged that few issues have provoked so broad and intense a reaction from foreign nations. JA-576. The State Department summarized the foreign nations' principal criticisms of worldwide combined reporting and characterized those criticisms as "sound":

- The unitary tax method imposes an onerous administrative burden, particularly for foreign-based multinationals. Foreign-based companies do not keep worldwide records in dollars, in English, or in accordance with U.S. accounting standards, but states imposing the worldwide method require reporting on those terms.
- The unitary tax method leads inevitably to extra-territorial and double taxation. The unitary method assumes uniform returns throughout the world, but international investment occurs precisely because such returns differ. Greater risk is reflected in relatively high rates of return as a compensation. The worldwide unitary method allows a state to reach beyond its borders and tax higher profits earned elsewhere.
- The unitary tax method is contrary to international practice. The League of Nations rejected formulary apportionment (unitary tax) many years ago. The United States and the other OECD members have actively supported adoption of separate accounting, with arms length adjustment, as the international standard, a method that more nearly corresponds with the way business is actually conducted.
- Use of the unitary tax method by states of the United States encourages the developing countries to adopt the same method.
- The unitary tax method discourages investment in those states that apply unitary taxation and in the United States generally since any state may adopt the method.

JA-575 to 79. *See also* JA 68 to 79, 113 to 17, 774 to 78.

In 1985, after years of diplomatic effort, the United Kingdom enacted retaliatory legislation which would deny certain treaty benefits to United States corporations operating in unitary states. JA-127 to 28, 141 to 48. The legislation had a chilling effect on the willingness of United Kingdom subsidiaries of such corporations to repatriate dividends. JA-603.

4. THE POSITION OF THE UNITED STATES.

The Federal Executive has steadfastly promoted and adhered to the use of arm's length separate accounting for the division of international income, has opposed the application of worldwide combined reporting to foreign multinational enterprises through all Administrations, both Democratic and Republican, confronted with this issue, and has consistently taken the position that such application is unconstitutional.

Initially in response to, and after study confirming, complaints from foreign governments on increased risk of double tax, administrative burden and possible retaliation, the United States added Article 9(4) to the tax treaty then being negotiated with the United Kingdom. PA A-18; JA-783. Article 9(4) would have required states to use the arm's length method when taxing affiliates of United Kingdom companies. *Id.* A reservation which would remove Article 9(4) from the Treaty was defeated in both the Senate Foreign Relations Committee and the full Senate. PA A-18; JA-243, 390-92. The Senate voted 49-32 (5 votes short of the necessary two-thirds) to ratify the Treaty including Article 9(4). PA A-18; JA-392 to 94. The Treaty was resurrected after parliamentary maneuvering in which the reservation was added without a separate vote, and the Treaty, with the reservation, was ratified by the Senate. PA A-18; JA-408 to 10. The reservation was subsequently included in the Third Protocol to the Treaty, which also contained other changes. Ex. 37B. The United Kingdom ratified the Treaty only after strong assurances from the United States that the matter of worldwide combined reporting would be resolved. PA A-18; JA-71, 793 to 94.

All Presidential Administrations since President Nixon have been faced with the issue and continued with efforts at solution. JA-771 to 74. In 1985, after passage of the United Kingdom

retaliatory legislation, President Reagan instructed the Secretary of Treasury to pursue a resolution to the problem through federal legislation and treaty negotiation, and instructed the Attorney General to ensure that the United States interests were represented in appropriate litigation. JA-191 to 92. The appearance of the United States as amicus curiae in support of Barclays in all three California courts, beginning with the trial court, and in this Court in support of Barclays' first petition for certiorari, was a part of such efforts.

Congress has enacted no legislation dealing with this issue. R 228 to 29. Ex. 37C at 89. Bills concerning unitary taxation have been introduced, but there has never been a vote in a congressional committee or in either house of Congress on such a bill. *See* PA A-31 to 32. None of the bills has dealt solely with worldwide combined reporting as applied to foreign multinational enterprises. *Id.*

5. CALIFORNIA LEGISLATION.

In 1986 California enacted legislation which allowed multinational businesses to elect out of the use of worldwide combined reporting in favor of a "water's edge" method which limited the entities to be combined for a California return. JA-696 to 745. The United Kingdom welcomed the passage of that legislation as a "major step toward complete withdrawal" of worldwide combined reporting, but expressed reservations about aspects of the legislation and stated that it would "continue to look for a comprehensive solution" as outlined by President Reagan. JA-746. The United States noted the California legislation had elements "inconsistent" with the President's statement (*inter alia*, the election fee), but suggested deferral of pending restrictive legislation to give California and other worldwide unitary states the opportunity to respond. Ex. 37I at 63-64.

6. SUBSEQUENT EVENTS.

Subsequent significant events, which have been called to the attention of this and other courts, have occurred.

Nations continued to lodge formal diplomatic protests with the United States and appeared as amici curiae in this and other litigation testing the constitutionality of worldwide combined reporting.[4]

On May 13, 1993, the United Kingdom announced that it would have to take retaliatory measures in relation to United States based companies if there was not a satisfactory resolution of the problem of the "internationally opposed unitary tax" on foreign-owned companies in California by the end of the year. PSA(1) N.

On June 30, 1993, the Finance Committee of the German Bundestag requested the German Government to take immediate steps to consider retaliation should it prove impossible to achieve a satisfactory solution to the problem of unitary taxation within a reasonable period of time. PSA(1) O.

In September, 1993, in direct response to foreign retaliatory pressures and persuasion by the Clinton Administration, California further amended its water's edge legislation effective for years beginning on or after January 1, 1994. PSA(1) L A-25; 1993 Cal. Stat. ch. 881.

On September 15, 1993, upon passage of these amendments to California's water's edge legislation, the United Kingdom announced that it would defer retaliatory action pending satisfactory application of such law. The United Kingdom reiterated its

[4]Letter from Ambassador of Spain Julian Santamaria to Secretary of State James Baker, dated June 30, 1989, attached to Brief Amicus Curiae on behalf of the Organization for Fair Treatment of International Investment (OFTII) and Union of Industrial and Employers' Confederations of Europe (UNICE), California Supreme Court; Note No. 91 from British Embassy to U.S. Department of State, dated July 22, 1992, attached to Amicus Curiae Brief of the Government of the United Kingdom, U.S. Supreme Court, No. 91-212; Note 30, USA, 6/1 from Royal Dutch Embassy to Secretary of State Warren Christopher, dated March 26, 1993, attached to Amicus Curiae Brief of the Member States of the European Communities and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland, U.S. Supreme Court, No. 92-1384.

position that, while the legislation in California was a significant step forward, by itself it could not provide a complete solution to the unitary tax problem. PSA(1) P.

On September 23, 1993, the Member States of the European Community and the Commission of the European Communities sent a note to Secretary of State Warren Christopher characterizing the legislation as "an improvement," but expressing the view that the unitary tax problem was not solved. PSA(1) Q.

On October 14, 1993, the Governments of the Member States of the European Communities (Belgium, Denmark, France, Federal Republic of Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain and The United Kingdom) and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland sent a note to the Secretary of State also stating that they did not consider the unitary tax problem resolved by the California legislation. PSA(2) R.

The United States opposed the granting of Barclays' second petition for certiorari after this Court requested its views. U.S. Am. Br., No. 92-1384. The United States did not disavow its prior positions that the application of the California method to foreign multinational enterprises was inconsistent with the established international practice to which the United States adhered, as well as a source of conflict, but contended that California's 1993 amendment of its water's edge legislation made the issue no longer one of recurring importance. *Id.*

7. THE ASSESSMENTS.

The California Franchise Tax Board audited the California tax returns of BBI and Barcal for 1977 and determined that BBI and Barcal were part of a worldwide unitary business conducted by the members of the Barclays Group. JA-11. The Franchise Tax Board assessed additional taxes of $4,076 to BBI and $254,699 to Barcal, subsequently reduced during the administrative process to $1,678 and $152,420, respectively. *Id.* BBI had originally filed its tax return for the income year 1977 on the basis that it was part of a unitary business composed of itself and its subsidiaries, but not its parent BBL and BBL's other subsidiaries. JA-12. BBI paid

with its original return $14,447.54. JA-11. Barcal had originally filed its tax return for the income year 1977 on an arm's length separate accounting basis and paid tax of $541,276.49. *Id.* Both BBI and Barcal protested the assessments on the basis, *inter alia*, that the correct method upon which to compute the tax was the arm's length separate accounting method. JA-12 to 13. The protests, later converted into claims for refund, were the basis upon which suit was brought. JA-13. BBI and Barcal paid the additional assessed taxes and filed suit for refund, challenging the constitutionality of the application of worldwide combined reporting to foreign-owned multinational groups. *Id.*

8. THE DECISIONS BELOW.

A. California Superior Court and Court of Appeal (First Opinion).

The California Superior Court held, and the California Court of Appeal affirmed, on the basis of substantial evidence,[5] that California's application of worldwide combined reporting to foreign-owned multinational groups violated the foreign Commerce Clause because it "impair[ed] federal uniformity in an area where federal uniformity is essential" and "prevent[ed] the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448, 451 (1979).

Both courts rejected the contentions of the Franchise Tax Board that five factors showed a congressional policy "to permit the states to tax as they please" by "negative acquiescence" without congressional legislation. In light of the distinctions between this case and *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), and the fundamental differences between the arm's length international standard and world-

[5]Although there were some stipulations, PA A-36, 70, *reprinted* at JA-8 to 49, the case was tried on a contested record. The Statement of Decision of the Superior Court (PA A) explains the factual and legal basis for its decision as to each of the controverted issues at trial. Cal. Civ. Proc. Code § 632.

wide combined reporting, both courts found that a direct adverse impact on foreign affairs from the use of worldwide combined reporting was "inevitable."[6]

The Court of Appeal also found a clear and thoroughly grounded policy of the Executive to require the use of the arm's length method to divide income of foreign multinational enterprises. That court further found that, in the face of congressional inertia and inaction and in an area where the Executive has traditionally been given great deference, this policy constituted a "clear federal directive" in favor of the arm's length method.

The Superior Court also found de facto discrimination amounting to economic protectionism against foreign owners because domestic enterprises did not have the compliance burdens which worldwide combined reporting placed on foreign-based multinational taxpayers. PA A-26 to 28. The Court of Appeal acknowledged that this legal analysis was based on substantial evidence, and mentioned that foreign anger was even more understandable "in light of the critical role the United States has played in attempting to construct a coherent and nondiscriminatory tax policy for all nations" based on separate accounting. PA B-26.

The Superior Court also ruled that the due process clauses of the California and United States Constitutions were violated. The first Court of Appeal opinion did not reach this issue.

B. California Supreme Court.

In reversing the decision of the Court of Appeal, the California Supreme Court recognized that it was "presented with a question left open in *Container*," PA C-3, but rejected analysis under the tests this Court set forth in *Container* and *Japan Line*. Rather, the

[6]The Court of Appeal affirmed the holding of the Superior Court that, even with the "definite risk of, as well as actual double taxation" in this case, worldwide combined reporting in this context did not fail the first additional test of *Japan Line* (double taxation). PA A-25 to 26; PA B-21. It is unclear if the Superior Court reached Barclays' contentions that the tax method also failed the first (nexus) and fourth (relation to services) tests of the dormant Commerce Clause. *See* PA A-21.

California court declared that *Wardair Canada v. Florida Department of Revenue*, 477 U.S. 1 (1986), had "reoriented" the dormant Commerce Clause and had reduced the scope for dormant Commerce Clause analysis so as to make such analysis "particularly inappropriate" in this case. PA C-19. Instead, "*Wardair* supplants what the court has termed the 'quagmire' of dormant commerce clause analysis ... with a heightened judicial attentiveness to expressions of congressional foreign commerce policy." PA C-21 (citation omitted). The court "abstracted" from *Wardair* "a kind of protocol for identifying those kinds of governmental silences that give rise to 'negative implications' supporting an inference of federal acquiescence in the state tax under challenge." PA C-23.

The California court constructed its own test to determine whether a state tax violated the foreign Commerce Clause: whether in the absence of legislation, Congress' inaction constituted a "pattern of congressional action" which "evidences both an awareness of [the] issue and a refusal to adopt the remedy urged upon it . . . ." PA C-38. The court took the same five items which the lower courts had rejected as evidence of congressional policy and under its new test treated them as "those kinds of governmental silences ... [implying] federal acquiescence in the state tax under challenge." PA C-23. The court never addressed the fact that this Court had considered the most important of these factors in *Container* (the failure of treaties to restrict or cover state taxes, Senate failure to pass the U.S.-U.K. Treaty with Article 9(4), no congressional legislation) as constituting neither explicit action nor congressional policy.

Because the "*Wardair* methodology interdict[ed] judicial resort to executive branch opinions as to the international commercial effect of a challenged state taxation practice . . . ," PA C-21, the California court rejected the views of the United States, appearing as amicus curiae, that California's use of worldwide combined reporting interfered with the "Federal Executive's conduct of foreign affairs." PA C-37 n.22.[7]

[7]The California court concluded that the "clear federal directive" test in *Container* was not part of the dormant Commerce Clause analysis.

Thus, the court did not consider the findings below of burden on commerce or the foreign policy implications in the application of worldwide combined reporting, including retaliation and threats of retaliation.

The court remanded the issues of the discriminatory effect of compliance burdens and due process to the Court of Appeal for further proceedings.

C. Court of Appeal (Second Opinion).

On remand, the Court of Appeal agreed that foreign-based corporate groups incurred significant administrative costs, greater than their domestic counterparts, to comply with the California system. PA D-9. However, the court concluded that the burdens were not unconstitutionally discriminatory because foreign and domestic corporations faced the same tax rate and had to furnish the same information, and because the burden was ostensibly alleviated by Regulation 25137-6, providing for the use of reasonable approximations. PA D-10 to 14.

The Court of Appeal further concluded that, in the context of a non-arbitrary application, Regulation 25137-6 did not result in unreasonable, undue or arbitrary costs of compliance and that the Regulation could be construed to contain constitutionally adequate standards to guide application of the Board's discretion to grant relief from the mandatory provisions of the Regulation. PA D-14 to 27.

SUMMARY OF ARGUMENT

This Court has recognized for well over 100 years that "the constitutional prohibition against state taxation of foreign commerce is broader than the protection afforded to interstate commerce..." *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue and Fin.*, 112 S. Ct. 2365, 2370 (1992) (citing *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434, 445-46 (1979)). Foreign commerce merits broader protection because "matters of concern

but served only to determine whether Congress had acted to preempt an otherwise valid state tax.

to the entire Nation are implicated." *Kraft*, 112 S. Ct. at 2370 (citing *Japan Line*, 441 U.S. at 448-51). State burdens on foreign commerce carry with them the potential for international retaliation that will harm and concern "the Nation as a whole," not just the offending state. *Japan Line*, 441 U.S. at 450. The broader protection accorded to foreign commerce also requires closer scrutiny in considering whether Congress has acted to permit such a burden. *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 92 n.7 (1984).

With these concerns in mind, this Court in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 189 n.26 & 195 n.32 (1983), expressly reserved the issue of the constitutionality of worldwide combined reporting, when applied to foreign-owned taxpayers. This case squarely presents that reserved question.

Japan Line and *Container* itself set forth the tests for resolving this question: (a) whether the tax as applied impaired federal uniformity in an area where federal uniformity is essential and prevented the Nation from "speaking with one voice" when regulating foreign commerce; and (b) whether the tax as applied created a substantial risk of multiple taxation. Under both tests, worldwide combined reporting is unconstitutional as applied to foreign-owned multinationals.

The violation of the "one voice" test here is unmistakable: California's use of worldwide combined reporting to divide income of foreign multinational corporations understandably has offended all of the major trading partners of the United States and has led to both threats of and actual retaliation. As the United States itself has acknowledged, few issues have provoked so broad and intense a reaction from foreign nations. There is an accepted international standard — the arm's length method — which has attained the custom of nations. Worldwide combined reporting, on the other hand, is a separate and different method to divide income which is incompatible with the international standard. It is perceived by foreign nations as an arbitrary, unfair, and predatory method of taxation, the use of which threatens the international standard, imposes unreasonable tax and compliance burdens on foreign-owned taxpayers, and discourages foreign investment in the United States. California's intrusion into this

area deeply affecting the foreign relations of the Nation as a whole also has caused the United States to appear repeatedly as amicus curiae in this case — in the three California courts and in this Court over a period of six years and through five Administrations — to express its view that worldwide combined reporting was unconstitutional under the "one voice" test.

Regarding multiple taxation, this Court in *Container* found that worldwide combined reporting did present a risk of multiple taxation, but that such multiple taxation was not inevitable and the risk of it was not unconstitutional as applied to a *domestic* multinational. Here, there is no question that worldwide combined reporting in fact has resulted in actual multiple taxation of foreign multinationals. Further, such occurrences of actual multiple taxation of foreign multinationals, together with the ever-present risk of such multiple taxation, constitute a significant international irritant. The incidence of this risk on foreign-owned taxpayers, and the resulting impact on foreign relations, makes multiple taxation a different problem in this context than in the context of domestic multinationals, and implicates the very concerns underlying the foreign Commerce Clause. Accordingly, the risk of multiple taxation in and of itself establishes the unconstitutionality of worldwide combined reporting as applied to foreign multinationals.

In response to this patent unconstitutionality under the *Japan Line/Container* tests, California has advanced two arguments, neither of which withstands scrutiny. First, California has argued that the dormant Commerce Clause, including these tests, does not apply here at all, as a result of this Court's decision in *Wardair Canada v. Florida Department of Revenue*, 477 U.S. 1 (1986). This argument was the basis for the California Supreme Court's decision, which ignored the analytical framework used by this Court in *Japan Line* and *Container*. Second, California has argued that subsequent events somehow transform the analysis in determining the unconstitutionality of worldwide combined reporting.

First, nothing in *Wardair* changes the longstanding rule, followed by this Court in numerous cases both before and after *Wardair*, that Congress must act clearly and unambiguously to

remove a state enactment from the reach of the dormant Commerce Clause. This rule has been applied with especial rigor in the sensitive area of foreign commerce. The California Supreme Court's opinion turns this rule on its head by concluding that congressional silence constitutes "acquiescence" sufficient to preclude any application whatsoever of the dormant Commerce Clause. In fact, as this Court itself concluded in *Container*, there is no congressional legislation either specifically permitting or specifically forbidding the use by the states of worldwide combined reporting to divide international income for tax purposes. Congress as a whole has not addressed the issue at all, and, to the extent the Senate visited the issue in the course of considering the U.S./U.K. Tax Treaty, a majority of the Senate twice expressed its *opposition* to worldwide combined reporting. Accordingly, the dormant Commerce Clause tests do apply here and cannot be avoided.

Second, subsequent events in no way change, let alone cure, the unconstitutionality of California's tax system for a period exceeding twenty years. Whether or not California's most recent legislation passes constitutional muster is not before this Court. In any event, it is prospective only, and does not change the analysis here.

California's tax method as applied in this case is unconstitutional on additional grounds as well.

1. Foreign policy is the exclusive prerogative of the Federal Government. Where, as here, state action interferes with the conduct of foreign affairs by the Federal Government, the Constitution itself preempts such action.

2. Worldwide combined reporting imposes prohibitive compliance burdens on foreign multinationals, significantly greater than those imposed on domestic corporations. This discriminatory impact on foreign commerce in and of itself is violative of the foreign Commerce Clause under this Court's precedents.

3. Because foreign multinational taxpayers cannot comply with the mandatory filing provisions of the California worldwide filing regulation without inordinate cost, they must rely on acceptance of information in lieu thereof by California. The lack of meaningful standards to provide guidance for exercise by California of the discretionary relief provision of the regulation constitutes a due process violation.

ARGUMENT

I. CALIFORNIA WORLDWIDE COMBINED REPORTING IS UNCONSTITUTIONAL UNDER THE FOREIGN COMMERCE CLAUSE.

A. This Court Has Established Criteria for Determining the Constitutionality of State Taxes Under the Foreign Commerce Clause.

A central concern of the Framers of the Constitution was that "to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation." *Hughes v. Oklahoma,* 441 U.S. 322, 325-26 (1979). The need for avoiding balkanization among the states is especially great with respect to foreign commerce, not only because of the concern that action by a single state might bring harm to the Nation as a whole, but also because of the need for the people of the United States to act through a single national voice on matters affecting the foreign relations of the entire country. *Wardair*, 477 U.S. at 8; *Japan Line*, 441 U.S. at 448-51; *Kraft*, 112 S. Ct. at 2370.

In the *Container* case, in concluding that worldwide combined reporting was constitutional when used to divide the international income of a domestic multinational enterprise, this Court determined that Congress had remained silent. Thus, the Court used a dormant Commerce Clause analysis, applicable when Congress has not affirmatively acted and where "it is the responsibility of the judiciary to determine whether action taken by state or local authorities unduly threatens the values the Commerce Clause was intended to serve. *See Southern Pacific Co. v. Arizona,* 325 U.S. 761 (1945)." *Wardair,* 477 U.S. at 7-8; *see also Japan Line*, 441 U.S. at 448-51.

This Court has adopted four tests under the dormant Commerce Clause to determine if a state tax satisfies basic interstate Commerce Clause requirements: (1) the tax must be applied to an activity with a substantial nexus with the taxing state; (2) the tax must be fairly apportioned; (3) the tax must not discriminate against interstate commerce; and (4) the tax must be fairly related to the services provided by the taxing state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). In *Japan Line*, this Court recognized the heightened need for uniformity in dealing with other nations when foreign commerce is implicated by adding two additional tests:

- whether the tax, notwithstanding apportionment, created a substantial risk of multiple taxation; and
- whether the tax impaired federal uniformity in an area where federal uniformity is essential and prevented the Nation from speaking with one voice when regulating foreign commerce.

Japan Line, 441 U.S. at 451.

With respect to multiple taxation, this Court pointed out that "[e]ven a slight overlapping of tax — a problem that might be deemed *de minimis* in a domestic context — assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." *Id.* at 456. A tax could prevent the Nation from speaking with one voice and frustrate achievement of federal uniformity by leading to international disputes over reconciling apportionment formulae, by creating asymmetry in the international tax structure leading to retaliation which causes harm to the Nation as a whole, not just to the state, and by increasing the potential for varying degrees of multiple taxation should other states follow the taxing state. *Id.* at 450-51. This Court concluded in *Japan Line* that the California tax at issue there not only produced multiple taxation in fact but also prevented the Nation from speaking with one voice. *Id.* at 451-52.

In *Container*, which involved the same California taxation method at issue here but applied to a domestic-owned multinational group, this Court reaffirmed the two additional *Japan Line* tests. The Court reemphasized that "double taxation in the

foreign commerce context deserves to receive close scrutiny," 463 U.S. at 189, but found it constitutionally significant that: (1) the tax in *Container* was on income rather than property; (2) double taxation was not an "inevitable" result of the California taxing scheme; and (3) the tax fell not on a foreign-owned business but on "a corporation domiciled and headquartered in the United States." *Id.* at 187-89. Elaborating on the "one voice" inquiry, this Court stated that a state tax at variance with federal policy would fail the one voice standard if "it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." *Id.* at 194.

The most obvious foreign policy implication of a state tax was the "threat it might pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole." *Id.* "[I]n the absence of explicit action by Congress," *id.*, to determine when foreign nations would be offended, this Court developed "objective standards" reflecting general observations about the imperatives of international trade and foreign relations. *Id.* When applied in the factual context of *Container, i.e.*, taxation of a domestic multinational enterprise, these factors weighed against the conclusion that the California tax might justifiably lead to foreign retaliation: the tax did not create automatic asymmetry in international taxation; the tax fell not on a foreign entity but on a domestic corporation; and, even if foreign nations had a legitimate interest in reducing tax burdens of domestic corporations, the amount of tax paid by the domestic taxpayer was more a function of the tax rate than the allocation method. *Id.* at 194-95. Finally, while stating that a state tax might have foreign policy implications other than the threat of retaliation, this Court noted the absence of an amicus brief by the Executive Branch. *Id.* at 195-96.

The Court then turned to the other prong of its test, violation of a clear federal directive, a "species" of preemption. This Court held that the failure of treaties to cover subnational taxes or to restrict states to the arm's length method, the failure of the Senate to pass the U.S.-U.K. Treaty with a provision that would have restricted state use of a non-arm's length method, and the failure of Congress to enact legislation restricting state taxation,

did *not* constitute preempting "specific indications of congressional intent." *Id.* at 196.

B. Tested by this Court's Criteria, Worldwide Combined Reporting as Applied here Is Unconstitutional.

This case involves the most obvious and unconstitutional foreign policy implication of a state tax: the threat of offense to our foreign trading partners leading to risk of, and actual, retaliation. It also involves clear frustration of U.S. policy, actual double tax, and aggravated risk of double tax. Tested by the criteria of *Japan Line* and *Container*, application of worldwide combined reporting to members of a foreign-owned multinational group, as here, is unconstitutional under the dormant foreign Commerce Clause.

1. Worldwide Combined Reporting Interferes with the Ability of the United States to Speak with One Voice.

Worldwide combined reporting undeniably implicates foreign policy issues which must be left to the Federal Government and prevents the Nation from speaking with one voice. Foreign nations have properly communicated their concerns not only over the burdens on their nationals from the inconsistent worldwide combined reporting system, but also over the possible unravelling of sixty years of cooperative effort among nations to establish the arm's length method as the exclusive international standard. Thus, this Court need not speculate as to the foreign policy implications of the application of the California method to foreign-owned enterprises. Whether measured under the "objective standards that reflect very general observations about the imperatives of international trade and international relations" as set forth by this Court in *Container*, 463 U.S. at 194, or under this Court's longstanding jurisprudence recognizing the special need for uniformity in external affairs, the application of the California method to divide the income of a foreign multinational enterprise clearly fails the "one voice" test.

a. Use of a Method Other than the International Standard Frustrates United States Policy and United States Trading Partners.

There is an express and well articulated policy of the United States on the system to be used for division of income of foreign multinational enterprises among nations for tax purposes. It is the arm's length method. JA-577, 600 to 603. The United States does not stand alone in selecting that standard. It is used by every major trading partner of the United States. JA-70, 600 to 03. No other method is used internationally. PA A-20.

As a result, foreign governments have bombarded the United States with steadily escalating complaints from the moment of California's application in the 1970's of worldwide combined reporting to foreign multinational enterprises. PA A-17, 24; JA-770 to 74. Few issues have provoked as broad and intense a reaction from foreign nations. JA-576. The reason is obvious: the intrusion of this different and incompatible method threatens to negate the over 60 years of effort by the United States and most of the developed and developing nations of this world in standardizing rules for the allocation of income to jurisdictions for the purposes of taxation. JA-98, 821 to 22; R 1129.

As part of its own economic policies, the United States has been a leader in fostering use of this method. R 63-64, 1138-39, 1168-69. The stakes involve more than a desire for orderliness. Harmonization of tax systems has been recognized by the United States as essential to its policy of free trade to encourage foreign investments in the United States, as well as to remove barriers to U.S. investment abroad. JA-86 to 87, 769, 822 to 23; Ex. 50B at 9.

The success of this effort is reflected in the network of treaties, model treaties, internal laws and cooperative efforts among nations. JA-822. The arm's length standard is the custom of nations. PA A-20; JA-813, 823 to 24, 826; R 1129-32.

Strong policy reasons underlie the use of a single standard. For international business, the use of an agreed upon standard: (i) mitigates the possibility of unrelieved multiple taxation by reducing the number of nations that claim the right to tax the

same income, R 1139-41; (ii) gives predictability for planning, R 1151-52; and (iii) harmonizes tax compliance requirements, *see* JA-77, 84 to 85. From the standpoint of nations, the use of a single standard is even more important: it sets the boundaries of a nation's claim to tax income, it protects that nation's commerce and trade by delineating the rules under which its nationals are taxed abroad, and it provides a consistent and uniform framework to discuss and resolve difficult and sensitive issues of international taxation.

Under the arm's length standard, each corporation is treated as a separate entity. JA-823 to 24; R 1124-25, 1172. A nation, while retaining the right to tax its domiciliaries in any way it wants, will tax a corporation, the ultimate ownership of which is foreign, only on the profits of that corporation in the host country and will not tax related corporations not otherwise present. JA-821; R 1125-26, 1172. Each jurisdiction customarily retains the right to examine transactions between related entities and to determine whether the transactions are done on a basis which is a realistic and economic reflection of the income of the parties. *See* Ex. 37I at 3 to 4; R 1126-28.

In contrast, worldwide combined reporting requires aggregation of the income of each entity which is a member of the so-called unitary group (whether or not doing business in the taxing jurisdiction) and determines the tax jurisdiction's share of this total tax base by a formula, usually an average of property, payroll and sales. PA A-21. Its underlying economic assumption, that the activity of the worldwide unitary business is equally profitable in all jurisdictions, conflicts with recognition under the arm's length method that an individual corporation operating under different market conditions can and will earn different rates of return. Ex. 37C at 35; Ex. 46N.

Nations have worked out formal and informal mechanisms to reconcile differences in the application of the arm's length method. JA-822 to 25; R 1154, 1166-67. There are no mechanisms available or possible to reconcile differences between the arm's length method and worldwide combined reporting. *See* JA-781, 824; R 1168-69.

Against this practical and historical background, both the United States and foreign governments have been seriously concerned about the implications of permitting worldwide combined reporting to exist concurrently with the arm's length method.

The United States cannot unilaterally enforce a particular standard for the division of multinational income among nations. It must instead depend on the cooperation and agreement of other nations. R 1167. The United States cannot insure that cooperation when a state frustrates the very purposes of an international standard by using a different and incompatible method. Thus, the use by the states of worldwide combined reporting has interfered with the United States' conduct of its foreign economic policy, of which the international standard is a part.

b. Use of Worldwide Combined Reporting in These Circumstances Results in the Clearest Foreign Policy Implication, Risk of Retaliation.

Use by a subnational unit of a method different than that used by its sovereign to allocate international income subverts the very purpose of the agreed upon standard. Foreign nations are offended. Such offense has led to threats of and actual retaliation. No state has the right to provoke such a response. *Japan Line*, 441 U.S. at 450-51.

Foreign offense here has been intensified because foreign nations perceive worldwide combined reporting as an arbitrary, unfair and predatory method of taxation. PA A-21. In their view this method threatens the international standard, imposes unreasonable tax and compliance burdens on foreign-owned taxpayers and discourages foreign investment in the United States. JA-775, 792-93; Ex. 37C at 34. The United States has agreed with these characterizations. JA-575 to 79, 775 to 79.

Unlike *Container*, this Court need not speculate here as to the offense and its result. The California Court of Appeal, in its first opinion affirming the trial court's findings on the basis of substantial evidence, summarized:

> Every single nation in the industrialized western world has sent letters to the United States government protesting the

> use of WWCR by American states. Many of these protests have also been directed to California. Among the most vigorous of these remonstrators has been Canada, by far the United States' largest trading partner, and Britain, this country's largest foreign investor. These protests have been sharp, frequent, and incessant over a number of years. There was also evidence that no other taxation issue had ever led foreign governments to deal directly with American states. Even high-placed officials of the Board acknowledged awareness of this international outcry.

PA B-22. The record contains over 35 demarches and other diplomatic communications, not just to the United States but even to the states themselves, all protesting use of this method. *See* JA-93 to 126, 129-40. These protests have continued. *See* p. 10, *infra.*

The dispute reached the highest level: Prime Minister Thatcher of the United Kingdom, Prime Minister Trudeau of Canada, and Prime Minister Nakasone of Japan all spoke or wrote to the President. JA-131, 753, 772 to 73.

Foreign offense led to more serious action and harm to the Nation. As the California Court of Appeal described:

> And it is not just talk. The ultimate test of diplomatic sincerity — watch what they do, not what they say — has been met here. In 1985, Britain passed retaliatory legislation withdrawing a tax advantage for U.S.-based corporations doing business in both Britain and a unitary tax state. Though Britain stopped short of pulling the procedural trigger to fully implement this legislation, the law had a retroactive provision that propelled many American companies into preimplementation compliance. Moreover, Britain cancelled a trade mission to Florida because that state applied WWCR to foreign-based multinationals. And there were other similar cancellations. There was also evidence the United States has had problems in negotiating treaties because of objections to WWCR.

PA B-22 to 23. *See also* JA-127 to 28, 575 to 79, 600 to 03.

The British retaliatory legislation is the most obvious foreign policy implication, but there were numerous others. The West Germans and the Dutch delayed treaty negotiations. JA-782. The French and Canadians insisted on an agreement to reopen treaty negotiations if an acceptable solution could be found. JA-478, 481 to 82, 570 to 71. The matter has consumed the time and resources of the United States and its trading partners as well as causing embarrassment to both. JA-780 to 81. As George Carlson, a senior Treasury official, testified, the United States was asked if it had one foreign policy or 51 foreign policies. JA-781.

What was the response of the United States? Through six Administrations, commencing with President Nixon, the Federal Executive has sought to limit the states' use of worldwide combined reporting in the international sphere. PA B-29 to 30; JA-771. The efforts by the Federal Executive, beginning with the addition of Article 9(4) to the U.S.-U.K. Treaty in the Nixon administration and continuing through the administrations of President Ford, President Carter, President Reagan, and President Bush, were consistent and constant.[8] PA A-19, 21; PA B-29 to 30; JA-783 to 86.

Secretary of State George Shultz warned the unitary states in letters to their governors, including California's:

> Your state's employment of the worldwide unitary method of tax accounting is at odds with the position of the United States and has become a source of conflict with foreign states.

JA-601. Further, the United States appeared as amicus curiae in this case in the three California courts, and in this Court in

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[8]These consistent efforts were sufficient for the California Court of Appeal to conclude that these constituted a "clear federal directive" which the application of worldwide combined reporting unconstitutionally violated. PA B-35. The record in this case ends during the Reagan administration. However, the United States continued to appear in this case as amicus curiae during the Bush administration. The Clinton administration's efforts in securing the 1993 California legislation are described in the California Legislative Committee Report at PSA(1) L A-25.

support of Barclay's first petition for certiorari, each time pointing out the severe effects upon United States foreign economic policy and condemning the method as unconstitutional.[9]

c. Whether Tested Under this Court's *Container* "Objective Factors" or Other Jurisprudence, the California Tax Method Leads to Justifiable Retaliation.

The record in this case overwhelmingly demonstrates the unconstitutional interference with foreign relations which the use of worldwide combined reporting creates in these circumstances. Under the tests of both *Container* and *Japan Line* this should be sufficient. Comparison with the "objective factors" of *Container* to determine if use of the tax might lead to justifiable retaliation is unnecessary here: the Court has clear evidence both of retaliation and its justification.[10] *Hines v. Davidowitz*, 312 U.S. 52, 63-64 (1941).

Nevertheless, this Court's "objective factors" reflecting the "imperatives of international trade" confirm that foreign nations are likely to retaliate and are justified in retaliating in exactly the circumstances herein.

(i) Automatic Asymmetry

First, there is automatic asymmetry in the system of international taxation to the disadvantage of foreign multinationals when states apply worldwide combined reporting to them. United States

[9]PA H-25 n.13; PSA(1) K A-13. In its most recent appearance in opposition to the grant of certiorari, the United States did not disavow its previous position that imposition of this method constituted a constitutional violation. U.S. Am. Br., No. 92-1384.

[10]This Court needed the "objective factors" in *Container* because it was dealing with a domestic multinational enterprise whose sovereign was the United States. Inconsistent treatment of domestic multinational enterprises, although perhaps undermining other values, could not *directly* affect rights of other nations. Thus, this Court could determine under the objective factors that retaliation, a response available only to a foreign sovereign, would not be appropriate or likely.

businesses are not subjected to this tax method by any nation. PA A-20; JA-821.

That the taxpayers are foreign clearly affects the risk of retaliation from such asymmetry. In *Container*, involving a domestic multinational, this Court considered only "inevitable" double taxation as creating asymmetry of constitutional significance. 463 U.S. at 188. However, in *Japan Line*, in the foreign context, this Court looked to the "competitive disadvantage" to foreign business from the use of inconsistent tax systems internationally, and the reaction of the affected government to this disadvantage. *Japan Line*, 441 U.S. at 453.

The double taxation present in *Japan Line* was one such disadvantage, but inconsistent tax systems can produce other disadvantages to a foreign taxpayer—and to a foreign sovereign—that can result in retaliation for many reasons. Matters *de minimis* in a domestic context become important where issues of national sovereignty are concerned. *Japan Line,* 441 U.S. at 456.

There is actual double taxation here and aggravated risk of double taxation from the inconsistent systems. PA A-25. Foreign multinational enterprises face greater exposure to risk of double taxation in these circumstances than do domestic multinational enterprises. PA A-26. Whether or not the aggravated risk of double taxation is sufficient in and of itself to make California's method unconstitutional (*see infra* subsection 2), it is certainly an important factor in gauging its impact on foreign relations for purposes of the "one voice" test. *See* JA-814.

Moreover, this type of double taxation affects the foreign sovereign. JA-779. Nations use the international standard as a means of limiting and managing double taxation. JA-822 to 23. As this Court recognized in *Container*, the potential for double taxation from differences in administrative interpretation is contemplated under the international standard and mechanisms exist to mitigate, if not eliminate, such double taxation. *See* 463 U.S. at 190-93. However, in the type of double taxation created here from a completely different and inconsistent system, the foreign nation is now being asked to accept degrees of multiple taxation stemming not from differences in administration, but from differences

in the basic allocation of rights to tax. Thus, a foreign nation loses the protective limits of the single standard, and the benefit of the bargain.

The interference is magnified because the resolution of double taxation issues may affect the foreign sovereign's treasury. If a corporation pays multiple taxes because of an aberrant system, there is less revenue for the domiciliary nation to tax, and there is also pressure on the domiciliary nation from its own nationals to relieve such additional taxation (usually by credit) at a cost to its own revenues. JA-779, 826 to 830. If the foreign nation refuses to do so, its own nationals bear the cost. See JA-74 to 75, 824 to 25. The direct interference with sovereign rights from this asymmetric tax is inescapable.

Further, the divergence in systems creates compliance burdens which a taxpayer does not face under the international system. PA A-26 to 29. Worldwide combined reporting requires the ongoing collection of worldwide tax information and translation into a worldwide state tax base under state tax accounting principles for all entities in the unitary group. PA A-27. Under the international system foreign businesses need not collect such worldwide information and certainly not in accordance with state tax accounting principles. PA A-26 to 27. Again, whether or not compliance burdens are unconstitutional in and of themselves, (*see infra* Part III), they indisputably offend foreign nations and are an important part of the analysis under the "one voice" test.

(ii) Incidence of Tax

The second objective factor is the incidence of tax. Here the incidence of tax falls directly on a foreign taxpayer as well as on a domestic subsidiary of a foreign affiliate, the *Japan Line* "side" of the equation. The "effective" incidence is on the foreign group. PA A-24; PA B-24.

This impact on foreign enterprises is constitutionally significant not only under *Japan Line* and *Container* but also other jurisprudence of this Court. This Court has long recognized that foreign governments have legitimate concerns over the protection of the rights of their nationals when such nationals are in another country. *Hines*, 312 U.S. at 64. Grave international controversies

"may arise from real or imagined wrongs to another's subjects inflicted, or permitted, by a government." *Id; see also Japan Line*, 441 U.S. at 450-51; *Chy Lung v. Freeman*, 92 U.S. 275, 279 (1875). Thus, that a foreign business is involved, whether directly as a taxpayer or indirectly as the ultimate parent, *see Franchise Tax Bd. v. Alcan Aluminium Ltd.*, 493 U.S. 331, 339 (1990), "concerns our international relations, in regard to which foreign nations ought to be considered and their rights respected." *Henderson v. Mayor of New York*, 92 U.S. 259, 273 (1875).

Accordingly, under the second objective factor, here retaliation is again foreseeable and proper.

(iii) Allocation method

Third, it is clear that the allocation method, not the tax rate, creates the problem. Here, the offense of foreign governments is not attenuated, it is immediate. Such governments are not only concerned that their taxpayers may pay more tax, they are also concerned that the unorthodox California system strips away the protections of the international standard. One of the purposes of the international standard is to avoid precisely the kind of administrative burdens and uncertainties which the incompatible California tax system produces. As described in Part III below, foreign taxpayers must either create a costly information gathering structure solely to comply with the California filing requirements or forego California tax benefits. PA A-27 to 28. If they file with California's so-called relief provisions, foreign multinational taxpayers pay on a different income base than their domestic counterparts. PA A-28; JA-788 to 91. Whether or not foreign businesses are paying too much tax, it is clear that they are paying a different amount of tax than domestic enterprises. Ex. 37A at 50. Measured in the realistic context of the international custom, it is the incompatible system, not the tax rate, which creates the retaliatory offense.

d. Foreign Policy Implications Have Continued.

The continuing Federal Government efforts to resolve the issue both before and after the U.S.-U.K. Treaty have been matched by foreign efforts through diplomatic and even non-diplomatic chan-

nels. *See* p. 10 *infra*. Thus, United States foreign policy continues to be implicated.

No state, not even California, may tell the United States, the United Kingdom or any nation how to conduct its foreign policy. *Japan Line*, 441 U.S. at 445; *Chy Lung*, 92 U.S. at 279; *Zschernig v. Miller*, 389 U.S. 429, 440-441 (1968).

2. California's Method Also Fails Under the Double Taxation Test.

Like the taxpayer in *Japan Line*, and unlike the taxpayer in *Container, see* 463 U.S. at 187 n.22, the taxpayers here unquestionably have established that double taxation has occurred. The Barclays Group placed its foreign tax returns in evidence. Ex. 52A to NN. On that and other evidence, the trial court found actual double taxation of BBI and Barcal, as well as a "more aggravated" risk, in general, of double taxation of foreign multinationals as compared to the domestic multinationals before the Court in *Container*. PA A-25 to 26.

The incidence of double taxation on foreign-owned, as opposed to domestic-owned, taxpayers is constitutionally significant. The *Container* Court itself emphasized the significance, for double taxation purposes, of the fact that the double taxation there fell on domestic-owned rather than foreign-owned taxpayers. 463 U.S. at 188-89. In *Container*, this incidence of tax was a critical factor outweighing the numerous "important" factors the Court identified as cutting *against* the constitutionality of worldwide combined reporting, even as applied to domestic-owned taxpayers. *See id.* at 187-93. These important factors militating toward unconstitutionality, taken from *Japan Line*, included the facts that: (1) "double taxation stems from a serious divergence in the taxing schemes adopted by California and the foreign taxing authorities," *id.* at 187; (2) "the taxing method adopted by those foreign taxing authorities is consistent with accepted international practice," *id.*; and (3) "our own Federal Government, to the degree it has spoken, seems to prefer the taxing method adopted by the international community to the taxing method adopted by California," *id.* All of these important factors indicating unconstitutionality are present here as well, and here — unlike *Container* —

the double taxation falls on foreign-owned rather than domestic-owned taxpayers.

The distinction for these purposes between foreign-owned and domestic-owned taxpayers is important both as a practical matter and in terms of the policies underlying the foreign Commerce Clause. Because foreign multinationals typically have more of their operations and entities outside of the United States, the breadth of double taxation and the degree of burden on foreign commerce are greater than in the case of domestic multinationals, which typically have a smaller share of their operations and entities outside of the United States. PA A-23. This impact is dramatically illustrated by the facts of this case: only three of the over 220 entities in the Barclays Group did any business at all in the United States. *Id.* In contrast, the large number of Barclays entities that did not do any business in the United States did do business in a total of 59 countries other than the United States, and over 98 percent of the revenue of the Barclays Group was received in countries other than the United States. *Id.* Since all of these other nations use the arm's length method (as the United States itself does at the national level), Barclays is subject to tax on these operations by all of these other nations. At the same time, because California's worldwide combined reporting method requires the taxpayers here to include all of these foreign operations in the tax base for California as well, the double taxation is actual and severe, as it was on the foreign-owned taxpayer in *Japan Line*.

That the tax here falls on the *Japan Line*, rather than the *Container*, side of the scale on the double taxation issue is further underscored by this Court's most recent analysis of the double taxation issue in *Itel Containers Int'l Corp. v. Huddleston*, 113 S. Ct. 1095 (1993). There, in upholding the constitutionality of a Tennessee sales tax imposed on a domestic container company, this Court emphasized: first, that the tax there fell on "a discrete transaction occurring *within* the State," *id.* at 1104 (emphasis added); and, second, that the state there gave a *credit* against its own tax for any tax paid in another jurisdiction on the same transaction, thereby "reduc[ing], if not eliminat[ing], the risk of multiple international taxation." *Id.* These very same

factors supporting the constitutionality of the tax in *Itel* point in the opposite direction here: California's worldwide combined reporting method includes operations *around the world* in its tax base; and California does *not* give any credit (or even a deduction) for taxes paid in foreign nations on operations in those nations. Cal. Rev. & Tax. Code §§ 23051.5(b)(7), 24345.

Although under the international standard mechanisms exist to resolve or mitigate double taxation, there is no way to resolve the double taxation created here. JA-824 to 25. Because California's system ignores the concept of geographic source of income (but instead takes a "slice" from everywhere), nations cannot even begin to resolve competing claims with California. See R 1175, 1188-1200. Nor can this Court sit as a tribunal to resolve such competing claims as it does in interstate commerce. *Japan Line*, 441 U.S. at 454. Since other states have in the past used and still use variations on worldwide combined reporting, a taxpayer is faced with varying degrees of multiple taxation with no way to resolve or mitigate these. All this the Court foresaw in *Japan Line*. All this has happened here.

For all these reasons, the tax here fails under the double taxation test.

C. Neither the *Wardair* Case nor Subsequent Events Support the Constitutionality of Worldwide Combined Reporting Applied in this Context.

In response to this patent unconstitutionality under the *Japan Line/Container* tests, California has advanced two arguments in an attempt to avoid application of those tests to the circumstances of this case. First, California has argued that the dormant Commerce Clause, including these tests, does not apply here at all as a result of this Court's decision in *Wardair*. PA C-26. Second, California argued below that subsequent events transform the analysis in determining the unconstitutionality of worldwide combined reporting. Neither argument withstands scrutiny.

1. *Wardair* Does Not Supplant this Court's Well-Established Dormant Commerce Clause Analysis.

In its opinion the California Supreme Court ignored this Court's well-established dormant Commerce Clause analysis on the basis that *Wardair* had supplanted such analysis. PA C-21 to 38. The court "abstracted" from *Wardair* "a kind of protocol for identifying those kinds of governmental silences that give rise to 'negative implications' supporting an inference of federal acquiescence in the state tax under challenge." PA C-23.

In fact, the California court's approach, patching together a number of unrelated Congressional "non-actions" into a "mosaic" of "acquiescence," has no basis in *Wardair* or any other jurisprudence of this Court.

a. *Wardair* Involved Clear and Affirmative Congressional Action.

Wardair concerned a state sales tax on a discrete transaction (purchase of fuel in Florida) occurring only within one national jurisdiction and including neither actual nor possible international multiple taxation. In *Wardair*, this Court strongly reaffirmed the policies of the dormant Commerce Clause, including a greater need for uniformity in the area of foreign commerce, but determined that the federal policy urged by the petitioner, reciprocal tax exemptions for aircraft, did not exist. On the contrary, "in the context of this case," the evidence demonstrated that the federal government had "affirmatively acted, rather than remained silent, with respect to the power of the States to tax aviation fuel." *Wardair*, 477 U.S. at 9. Congressional action constituting law came from the Chicago Convention, a treaty entered into by the United States and 156 other nations, which by its terms precluded the imposition of local taxes on fuel in certain circumstances but did not prohibit the taxation of fuel in the circumstances before the Court. This text demonstrated:

> the international community's awareness of the problem of state and local taxation of international air travel, specifically aviation fuel, and represent[ed] a decision by the parties to that Convention to address the problem by curtailing and

> limiting only some of the localities' power to tax, while implicitly preserving other aspects of that authority.

Wardair, 477 U.S. at 10. Subsequent treaties, including the United States/Canadian Treaty, dealt only with national taxes, leading to the inference that Congress had "negatively acquiesced" in the Florida tax. That conclusion was bolstered by (i) the existence of Canadian provincial taxes similar to that of Florida (an indication that there was no uniform policy and thus no national consensus against such taxes); and (ii) the lack of any challenge to the localities' tax until recently.

This Court emphasized several times in *Wardair* that its decision was in the context of the case and explicitly said that it was not addressing — and the opinion should not be understood as addressing — whether, in the absence of these international agreements, the foreign Commerce Clause would invalidate Florida's tax. *Wardair*, 477 U.S. at 13.

This Court proceeded in *Wardair* against an extensive background of enacted congressional legislation — the Federal Aviation Act domestically and the Chicago Convention internationally — both of which dealt with state sales taxes and the latter with state sales taxes on aviation fuel. *See* Frederick R. Fucci, *Allowing State Taxation of Foreign Carrier's Fuel: Wardair Canada, Inc. v. Florida Department of Revenue*, 40 Tax Law. 419 (1987). In contrast, in this case there is no seminal statute or other enactment which addresses the specific problem and represents international agreement. On the contrary, there is vehement and unrelenting international opposition. This case, involving worldwide activities in a myriad of nations and conflict with a well established international standard, is a far cry from the discrete sales tax of *Wardair* touching only one nation.

b. Clear and Affirmative Congressional Action is Required to Supplant Dormant Commerce Clause Analysis.

Nothing in *Wardair* changes the longstanding rule, followed by this Court in numerous cases both before and after *Wardair*, that Congress must act clearly and unambiguously to remove a state

enactment from the reach of the dormant Commerce Clause. "Congress must manifest its unambiguous intent before a federal statute will be read to permit or approve of such a violation of the commerce clause. . . ." *Wyoming v. Oklahoma*, 112 S. Ct. 789, 802 (1992); *see also Maine v. Taylor*, 477 U.S. 131, 139 (1986); *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 91; *Sporhase v. Nebraska ex rel. Douglas*, 458 U.S. 941, 960 (1982). The burden rests on the state to demonstrate such clear and unambiguous intent. *Wyoming v. Oklahoma*, 112 S. Ct. at 802.

The need for affirmative approval of the state statute or regulation is "heightened" when the statute has "substantial ramifications beyond the Nation's borders." *South-Central Timber*, 467 U.S. at 92 n.7. A consistent and coherent foreign policy, the exclusive responsibility of the Federal Government, requires that "congressional authorization not be lightly implied." *Id.*

This Court has held that congressional intent was not demonstrated by: (i) the reservation to the states of the regulation of local utility rates in the Federal Power Act (*Wyoming v. Oklahoma*); (ii) consistency of state regulation with federal legislation (*South-Central Timber*); (iii) deferral by Congress to state law in 37 statutes (*Sporhase*); or (iv) approval by Congress of several interstate water compacts (*id.*). The congressional enactment must be "an affirmative grant of power to the states to burden . . . commerce 'in a manner which would otherwise not be permissible.' *Southern Pacific Co. v. Arizona ex rel. Sullivan* [325 U.S. 761,] 769 [(1945)]." *New England Power Co. v. New Hampshire*, 455 U.S. 331, 341 (1982).

Itel Containers Int'l Corp. v. Huddleston, 113 S.Ct. 1095 (1993), reaffirms the applicability of dormant Commerce Clause analysis in the absence of a specific congressional enactment. In that case, involving a sales tax on container leases, this Court used the dormant Commerce Clause analysis of *Japan Line* and *Container* in determining whether the Tennessee tax created substantial risk of international double taxation or interfered with the nation's ability to speak with one voice. *Id.* at 1104. Some congressional action prohibiting certain types of state taxes but not the tax at issue, conjoined with the statement by the United States, appearing as amicus curiae, that the Tennessee tax did not

conflict with international custom, supported this Court's conclusion that the Tennessee tax did not violate the "one voice" prong of this Court's dormant Commerce Clause analysis. This Court found no preemptive force in such nonspecific enactments. *Id.* at 1102.

In this case there is no federal enactment which would even suggest any grant of power to the states to use a method contrary to the international standard. The California court opinion is just a variation on the old argument that states are free to tax as they choose until Congress stops them. This approach would, of course, eliminate the dormant Commerce Clause. This Court responded to a similar argument by California in *Japan Line*:

> The premise of appellees' argument is that a State is free to impose demonstrable burdens on commerce, so long as Congress has not pre-empted the field by affirmative regulation. But it long has been "accepted constitutional doctrine that the commerce clause, without the aid of Congressional legislation . . . affords some protection from state legislation inimical to the national commerce, and that in such cases, where Congress has not acted, this Court, and not the state legislature, is under the Commerce Clause the final arbiter of the competing demands of state and national interests." *Southern Pac. Co. v. Arizona ex rel. Sullivan,* 325 U.S. 761, 769 (1945). *Accord, Hughes v. Oklahoma, ante* at 326, and n.2; *Boston Stock Exch. v. State Tax Comm'n,* 429 U.S. 318, 328 (1977).

441 U.S. at 454-55. *See also Wyoming v. Oklahoma,* 112 S. Ct. at 802. In the sensitive area of foreign commerce, to permit a state to even act in matters directly affecting international relations seriously threatens the basic constitutional allocations of power between the federal government and the states. *See also infra* Part II.

This Court's *Kraft, Itel* and *Wyoming v. Oklahoma* decisions, subsequent to *Wardair*, confirm that *Wardair* suggests neither a change in course on sensitivity to foreign commerce nor the retrenchment claimed by the California court in the need for clear

and affirmative congressional approval to remove cases from the reach of the dormant Commerce Clause.

c. The Decision of the California Supreme Court Contradicts the Conclusions of this Court in *Container*.

The California court's determination that *Wardair* had "reoriented" dormant Commerce Clause analysis also contradicts the conclusions of this Court in *Container*.[11] This Court in *Container* specifically held that the failure of treaties to cover subnational taxes or to restrict states to the arm's length method, failure of the Senate to pass the U.S.-U.K. Treaty with a provision which would have restricted state use of a non-arm's length method, and failure of Congress to enact legislation restricting state taxation did not constitute "specific indications of Congressional intent." *Container*, 463 U.S. at 196. Nevertheless, the California court relied on the same items as evidence of congressional "acquiescence" amounting to ratification of the state's use of worldwide combined reporting. PA C-34.

If such items evidence a congressional policy sufficient to remove this case from the dormant Commerce Clause, why did this Court bother with its analysis in *Container*, grounded as it is on the "absence of explicit action by Congress" and "no specific indications of Congressional intent." *Container*, 463 U.S. at 194, 196.

As this Court has recognized, Congress as a whole has not addressed at all the issue of a state's use of worldwide combined reporting to divide international income of foreign multinational enterprises. To the extent the Senate visited the issue in the course of considering the U.S.-U.K. Tax Treaty in 1978, a majority of the Senate twice expressed its *opposition* to worldwide combined reporting. *See supra* p.8. Nevertheless, the California

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[11]The California court never considered why this Court's discussion of California worldwide combined reporting subsequent to *Wardair* continues to refer to both *Japan Line* and *Container* as the controlling precedents without mentioning *Wardair* or "reorientation." *See Franchise Tax Bd. v. Alcan Aluminium, Ltd.*, 493 U.S. 331, 334-35.

court would have the stalemate created by the minority in the Senate over Article 9(4) become an explicit "refusal" to act, and "evidence" of Congress' "exercise" of its power to regulate commerce. On the contrary, this sequence of votes, if anything, indicates a Senate *preference* to restrict states' use of worldwide combined reporting.[12]

The California court's other "items" (failure of Congress to enact legislation, omission of state taxes from bilateral tax treaties, and treaties of friendship, commerce and navigation) are remote and general. Congressional legislation never dealt exclusively with the application of worldwide combined reporting in the foreign context and none of the legislation ever came to a vote in committee or in either house of Congress. *See* p. 9, *supra*. Many of the bilateral tax treaties preceded the advent of the application of worldwide combined reporting to foreign enterprises and, except for Article 9(4), never dealt with worldwide combined reporting or even state taxes (except in nonsubstantive discrimination clauses). The Treaties of Friendship, Commerce and Navigation in the record also preceded the application of worldwide combined reporting to foreign multinationals and, contrary to the California court, the commentary to the U.S. State Department Standard Draft Treaty makes clear that the allocation language cited was intended to prevent divergence from the international standard. *See* Ex. 33C at 202 n.12. *See also* A.W. Granwell et al., *Worldwide Unitary Tax: Is It Invalid under Treaties of Friendship, Commerce and Navigation?*, 18 Law & Pol'y Int'l Bus. 695, 735-740 (1986). Finally, the conduct of the Federal Executive, both before and after the negotiation of Article 9(4), reflected a consistent policy of limitation of the application of worldwide combined reporting to foreign multinationals to the water's edge of the United States.

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[12]The reservation was added to the treaty without a vote because proponents of the reservation feared another defeat and proponents of the treaty did not wish to be seen as supporting the reservation. JA-406 to 07. The record also indicates that certain of the opposition was not to limiting states' use of worldwide combined reporting, but to the use of the Treaty as the mechanism. *See, e.g.*, JA-251, 278.

d. "Awareness" Is Not a Substitute for Affirmative Legislation.

This Court in *Wardair* relied upon legislation dealing with the problem at hand. This Court emphasized not only the international community's awareness of the specific problem at issue, but also its agreement to a particular solution evidenced by a legislative text in the form of the Chicago Convention, signed and executed by 157 signatories. No such text exists here, and, as the record clearly demonstrates, no such international consensus on the "solution" which the California court proposes, namely to let the states tax as they please. However, there is certainly an international consensus not to permit the application of this aberrant method to foreign enterprises. The California court's approach is not a careful mosaic, but a kaleidoscope in which it twists the various pieces into different patterns to suit the moment.

2. Subsequent Events Do Not Eliminate Unconstitutionality.

In 1986, California enacted so-called water's edge legislation, effective for years 1988 and thereafter, permitting an election to use a method other than worldwide combined reporting. JA-696 to 745. Neither the United States nor its foreign trading partners saw the California legislation as a resolution of the unitary tax problem. JA-746; Ex. 371 at 64.

In 1993, the California Legislature amended its water's edge legislation for years beginning on or after January 1, 1994, but continued worldwide combined reporting as its basic method.

California contended below that the 1986 legislation "solved" all problems retrospectively so that no constitutional violation existed. *See* Appellant Board's Opening Brief (California Supreme Court) at 37. Prospective legislation cannot cure past unconstitutionalities, (*see Dennis v. Higgins*, 498 U.S. 439, 448 (1991); *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18, 44 (1990)), nor for that matter can a single state adopt its own resolution to a national problem. *Japan Line*, 441 U.S. at 457.

The 1993 California amendments are not before this Court, but Barclays would disagree with any suggestion that these are a resolution. The new legislation does not comport with the international standard and continues disparate treatment, both facially and in effect, for those who elect. Recent cases of this Court suggest that such burdens are significant and are unconstitutional. *See, e.g. Allied-Signal, Inc. v. Director, Div. of Taxation,* 112 S. Ct. 2251 (1992); *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Fin.*, 112 S.Ct. 2365.

In any event, prospective legislation cannot cure over 20 years of unconstitutionality.

II. WORLDWIDE COMBINED REPORTING INTRUDES INTO AN INHERENTLY FEDERAL AREA. IT IS PRE-EMPTED BY THE UNITED STATES CONSTITUTION.

The Constitution assigns no role to the states in the conduct of foreign policy:

> Governmental power over internal affairs is distributed between the national government and the several states. Governmental power over external affairs is not distributed, but is vested exclusively in the national government.

United States v. Belmont, 301 U.S. 324, 330 (1937). Where state legislation or action interferes with the conduct of foreign affairs by the Federal Government, the Constitution itself preempts it. *Zschernig v. Miller,* 389 U.S. 429. This is true even when the state legislation or action is in an area which states have traditionally regulated. *Id.* at 440.

In *Zschernig*, this Court set forth the test for this type of preemption: state legislation must fall where it has "a direct impact on foreign relations and may well adversely affect the power of the central government to deal with those problems." *Id.* at 441. In that case, the Court held that an Oregon statute that denied nonresident aliens inheritance rights in certain circumstances was unconstitutional because:

> [I]t has more than "some incidental or indirect effect in foreign countries," and its great potential for disruption or embarrassment makes us hesitate to place it in the category of a diplomatic bagatelle.

Id. at 434-35. The Court later noted that:

> The Oregon law does, indeed, illustrate the dangers which are involved if each State, speaking through its probate courts, is permitted to establish its own foreign policy.

Id. at 441.

The record in this case demonstrates that the use of worldwide combined reporting in these circumstances has had a direct impact on foreign relations and has interfered with federal conduct of foreign policy. *See* PA A-23 to 25; JA-575 to 79, 600 to 03. *See also* PA B-32, 53 to 54. The California method conflicts with the established international standard to which the United States and other nations of the world adhere, and the resultant disruption and embarrassment to the United States (as a leader in the development of the standard) are well documented. The United States' embarrassment was even greater because the Executive, charged with the negotiation of foreign policy, felt that the complaints were justified. JA-576, 774 to 78, 780-81.

Further, there can be no greater "disruption" to foreign policy than foreign retaliation, the ultimate result of state interference. This Court has expressed in case after case its concern that state interference in the sensitive area of external relations can lead to retaliation which will harm the Nation as a whole. *See Zschernig*, 389 U.S. at 440-41; *Hines v. Davidowitz*, 312 U.S. 52; *The Chinese Exclusion Case*, 130 U.S. 581 (1889); *Chy Lung v. Freeman*, 92 U.S. 275; *Henderson v. Mayor of New York*, 92 U.S. 259. Because of this threat, foreign policy must remain the prerogative of the central government, not of the states.

III. WORLDWIDE COMBINED REPORTING IMPOSES DISCRIMINATORY COMPLIANCE BURDENS ON FOREIGN COMMERCE.

One of the aspects of worldwide combined reporting which has offended foreign nations, and interfered with the conduct of this country's foreign relations, is the prohibitive administrative burden imposed on foreign multinationals by California's system. *See*

supra Part I, section B. As the courts below found, this compliance burden is greater than for domestic corporations. This discriminatory impact on foreign commerce in and of itself violates the foreign Commerce Clause, under the antidiscrimination component of this Court's Commerce Clause test.

A. California's Compliance System Discriminates Against Foreign Multinationals.

The courts below found that the compliance burdens imposed on foreign taxpayers by California's worldwide combined reporting system are significant and greater than those incurred by domestic taxpayers. PA D-9. Indeed, in its first opinion the California Court of Appeal, agreeing with the trial court's assessment of these costs as "prohibitive",[13] characterized the compliance requirements of worldwide combined reporting as an "administrative nightmare" for the foreign taxpayer. PA B-25. This nightmare arises from the fact that, solely to file a California tax return, the foreign taxpayer is forced to convert its diverse financial and accounting records from around the world into the language, currency, and accounting principles of the United States. PA A-26 to 27; PA B-25; JA-50 to 57, 66 to 67, 804 to 05; Ex. 37D at 4-7; R 1162-65, 1173-75. This prohibitively expensive process is not required by the arm's length method: under the international standard, Barclays would report to California only its business activities in the United States, the records for which are already available in English, the dollar currency, and United States accounting principles. JA-795, 800, 804 to 05.

[13] The trial court found that the cost to set up and maintain a system was "huge, over $5,000,000.00 to establish and over $2,000,000.00 annually to maintain." PA A-27 to 28; *see also* JA-58 to 65, 754, 809 to 10. Thus, the cost of compliance in the first year would have been greater than the amount of California income and many times greater than Barclays' total tax for 1977, as calculated by California. PA A-38 to 39. This is a constitutionally significant consideration. *Toomer v. Witsell*, 334 U.S. 385, 396-39 (1948); *Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520, 527-28 (1959); *Raymond Motor Transport, Inc. v. Rice*, 434 U.S. 429, 445-47 (1978).

Domestic-based multinationals already keep most of their records in English, in United States currency, and in accord with United States accounting principles. PA D-9. They incur significantly lower administrative costs to comply with California's worldwide combined reporting system, and in doing business abroad do not have to create a second and separate system to report their worldwide operations to another country. PA A-28; JA-801 to 02, 804, 811-12. Accordingly, the compliance burdens of worldwide combined reporting are not an inherent cost of doing business in a foreign land. All nations, including the United States, observe the international practice and do not require inquiry beyond the operations of the entity in their respective countries.

B. Presumed Facial Neutrality Will Not Save a State Tax from Unconstitutionality Where There Is Discrimination in Effect.

Notwithstanding these prohibitive and discriminatory compliance burdens on foreign multinationals, the lower court determined that such compliance burdens were not unconstitutional because California asked for the same information from and applied the same tax rate to all taxpayers. PA D-10.

A burden upon commerce imposed by a state will not be sustained merely because the state enactment on its face applies the same terms to the people of all states, including the state enacting the requirement.[14] *Fort Gratiot Sanitary Landfill, Inc. v. Michigan Dep't of Natural Resources*, 112 S. Ct. 2019, 2025

[14] The California court's attempt to justify the discrimination against foreign multinationals, by asserting that the cost to create and maintain a California compliance system for domestic multinationals is also prohibitive, misses the mark. If anything, this conclusion supports a holding of discrimination against all foreign commerce, whether part of a domestic or a foreign multinational's operations. In any event, the Court of Appeal itself acknowledged that there is an *additional* compliance burden on foreign multinationals. That difference is constitutionally significant. *Maryland v. Louisiana*, 451 U.S. 725, 756-60 (1981); JA-801 to 02. *See also Kraft Gen. Foods Inc. v. Iowa Dep't of Revenue & Fin.*, 112 S. Ct. 2365.

(1992); *Brimmer v. Rebman*, 138 U.S. 78, 82 (1891). "Facial neutrality" is no protection. Under well-established authority of this Court, a state's power may not be used with the aim *or the effect* of discriminating against interstate or foreign commerce. *Hunt v. Washington State Apple Advertising Comm'n*, 432 U.S. 333 (1977); *Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232 (1987); *Nippert v. City of Richmond*, 327 U.S. 416 (1946).

Here, the discriminatory effect — and its unconstitutionality — are clear. This Court's decision in *Hunt* is instructive. In *Hunt*, this Court held that a North Carolina provision, barring all grades other than USDA on sales of apples in closed containers, had the *practical* effect not only of burdening interstate sales of Washington apples, but also of discriminating against them. The discriminatory provision raised the costs of doing business in the North Carolina market for Washington apple growers and dealers, while leaving those of their North Carolina counterparts unaffected. This Court pointed out: "the increased costs imposed by the statute would tend to shield the local apple industry from the competition of Washington apple growers and dealers who are already at a competitive disadvantage because of their great distance from the North Carolina market." 432 U.S. at 351.

Here, California's compliance requirements clearly raise the cost of doing business in the California market for foreign multinationals, and — indeed — to a "prohibitive" level. PA A-27; JA-803, 805-06. Domestic multinationals incur lesser burdens in California and do not incur the incremental costs of responding to an entirely different set of worldwide information requirements when they do business abroad. Domestic multinationals also retain the economic benefits of the compliance systems they have established under the international standard. As in *Hunt*, this discriminatory impact constitutes a competitive disadvantage for foreign multinationals, and a preference in favor of domestic interests. This "economic protectionism," PA A-28, plainly is unconstitutional.

C. Filing a California Tax Return on the Basis of "Reasonable Approximations" Increases, Not Eliminates, Discrimination.

Contrary to the Court of Appeal's conclusion, PA D-15 to 16, 19, this unconstitutional discrimination is not cured by the discretionary relief provision of California's worldwide filing regulation. The purpose of California Code of Regulations, Title 18 § 25137-6 (PA J) (the "Regulation") is to convert financial information of a multinational unitary business to California tax reporting standards. The court below agreed that no foreign multinational could comply with this Regulation without prohibitive cost but concluded that the foreign taxpayer could avoid cost by using "reasonable approximations" under the discretionary relief provision of subdivision (e).

Such a system is unworkable and uncertain,[15] JA A-798, 805 to 09, but, apart from that, the relief provision itself creates further discrimination. JA-794 to 95, 806 to 09. As the trial court found, and the Court of Appeal did not deny, to obtain certain tax benefits under California law (*e.g.*, California tax depreciation) foreign multinationals must produce information or schedules for their worldwide operations in accord with the California tax principles. PA A-27; JA-788 to 791, 806 to 08. *See also* JA-794 to 95.

The "practical effect" of California's compliance requirements is that foreign multinationals are left to file their tax returns on the basis of consolidated financial statements and regulatory reports.[16] Tax accounting and financial accounting are admittedly different; one does not and should not normally use the account-

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[15] The Court of Appeal sanctions wholesale non-compliance with the Regulation. Since foreign multinationals can not comply with the mandatory provisions of the Regulation (i.e. "literal compliance"), all must file by approximation and thereafter negotiate their tax liability. This results in a system of court sanctioned "taxation by negotiation" — a due process violation. *See infra* Part IV.

[16] If California does not accept such approximations the penalty to the foreign taxpayer is "terribly onerous": it must produce the underlying records and file in accordance with "the literal requirements" of the

ing appropriate to an annual shareholder's report to prepare and file an income tax return, in California or elsewhere. PA A-26; JA 801 to 02. As a consequence, the income on which foreign multinationals pay tax is different (and typically greater) than that for domestic multinationals.[17] JA-788 to 91.

Accordingly, whether the discrimination takes the form of prohibitive compliance burdens or lost tax benefits or both, it violates the antidiscrimination component of this Court's basic Commerce Clause test.

IV. CALIFORNIA'S TAX FILING REGULATION VIOLATES DUE PROCESS.

A foreign multinational cannot, without inordinate cost, file a California tax return in accordance with the "mandatory" provisions of Regulation 25137-6 (*i.e.*, subdivisions (a) through (d), PA J-1 to 8). D-19. Such a multinational must rely on acceptance by California, under subdivision (e) of its Regulation, of information in lieu of that which is required. JA-840 to 43. When every foreign multinational must rely on the discretion of the taxing authority to file its tax return, discretion itself becomes the system. JA-860. The California trial court found that this constituted taxation by "supplication and negotiation" and a due process violation. PA A-29.

This Court requires that a statute or regulation contain sufficiently explicit standards, not only to permit a person of ordinary intelligence to understand what conduct is prohibited, but also to prevent arbitrary, harsh and discriminatory enforcement by government officials. *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972); *Kolender v. Lawson*, 461 U.S. 352, 360 (1982); *Papachristou v. City of Jacksonville*, 405 U.S. 156, 162, 168-169

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regulation. JA-804. California's own expert agreed filing under the literal requirements was unreasonable. *Id.*

[17]To further compound the problem, there are differences in tax effect when a foreign multinational must convert worldwide information to U.S. accounting standards and the dollar currency. *See* Roy E. Crawford, *Currency Exchange Problems in California's Worldwide Unitary Taxation*, 40 Bull. for Int'l Fiscal Documentation 378, 378-79 (1986).

(1972). A court may interpret the language of a regulation to determine whether it contains the necessary standards for due process purposes, but the provision so interpreted must itself pass constitutional muster. *See Kolender*, 461 U.S. at 358.

The California court asserted that no due process violation occurs here because the judiciary can ostensibly judge the reasonableness of California's exercise of discretion by weighing cost to develop information against a taxpayer's profferred approximations. *But see* JA A-807 to 08. The California court's interpretation of the regulation does not solve its constitutional infirmities.

The grant of standardless discretion itself violates due process; a taxpayer need not suffer actual harm from arbitrary application. *Chy Lung v. Freeman*, 92 U.S. 275; *Yick Wo v. Hopkins*, 118 U.S. 356 (1886). Foreign multinationals remain at peril in filing their tax returns because there is no standard to determine what "approximations" will be accepted.[18] JA-860. Information accepted varies from year to year and from auditor to auditor. JA A-805 to 09. It is difficult if not impossible for a taxpayer to establish a compliance system given this uncertainty. *See* JA-794 to 95, 798.

Filing on approximations also means not only that the foreign multinational loses tax benefits, but also that it pays tax on a different measure of income than do its domestic competitors. *See* Part III *supra*. Discrimination in effect is not an answer to California's standardless and arbitrary "relief" provision. In this sensitive area affecting foreign relations, a system of taxation by discretion cannot stand. *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue and Fin.*, 112 S. Ct. at 2365; *Chy Lung v. Freeman*, 92 U.S. at 275.

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[18]The California court seems to equate "approximations" with financial information. Since the purpose of the Regulation is to *convert* financial information, the taxpayer is still left with uncertainty as to what or how much is acceptable. The other "relief" provisions have similar vices. *See* JA-805 to 09. Failure to guess correctly can result in penalties. *See* PA B-27.

CONCLUSION

No state tax issue in recent memory has created the international furor of worldwide combined reporting. For all the reasons stated herein, the application of this method in these circumstances is clearly unconstitutional.

Respectfully submitted,

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APPENDIX

APPENDIX I

RULE 29.1 LIST
BARCLAYS' LESS THAN 100% OWNED SUBSIDIARIES

Subsidiary	Ownership Interest
Europe Asia Dynamic Fund Management Co. SA	70.00%
Massey-Ferguson Leasing Ltd.	75.00%
NB Geotech Finance Ltd.	51.00%
Fiatagri Finance Ltd.	51.00%
Barmac (Estates) Ltd.	50.10%
Blocksite Ltd.	50.20%
Bramingham Park Ltd.	50.10%
Chadacre Developments Ltd.	50.10%
Charmtape Ltd.	50.10%
Growlimit Ltd.	50.10%
J.V. Developments Ltd.	50.10%
Loopbeam Ltd.	50.10%
Mervest (Hendon) Ltd.	70.00%
Mervest (Sloane) Ltd.	51.00%
PSA Credit Company Ltd.	50.01%
Regmore Developments Ltd.	50.20%
Regmore Homes Ltd.	50.10%
Royco Business Parks Ltd.	50.10%
Wates-Barclays-Mercantile Homes Ltd.	50.01%
Wadham Stringer Credit Company Ltd.	75.00%
Barclays Motor Finance Ltd.	75.00%
Barclays Motor Wholesale Pty. Ltd.	75.00%
Barclays Bank of Botswana Ltd.	74.86%
Barclays Pensions Management Consultants (Pty.) Ltd.	74.86%
Barclays Bail SA	99.99%
Barclays Gestion SA	99.99%

Subsidiary	Ownership Interest
Barclays Immobilier SARL	99.95%
Barclays Invest Ltd.	99.99%
Barclaymur SA	99.99%
Financiere Laffitte	99.99%
Laffitte Capital	99.99%
Laffitte Patrimoine	99.99%
Laffitte Gastion	99.80%
Laffitte Investissement	99.99%
Laffitte Securities SA	99.99%
S.A.G.O.	99.99%
S.C. Des Garages du 21 Rue Laffitte	57.50%
Lutetia Societe Financiere SA	99.94%
Soc de credit Pour acquistion et amelioration des Immeubles	99.98%
S.F.G.C. (Group Barclays)	99.99%
Immogestion Barclays SA	99.90%
Society Civile Immobiliere Barclays IMMO-Hexagone	99.93%
Barclays Bank Botswana Nominees (Pty) Ltd.	74.86%
Barclays Bank of Ghana Ltd.	60.00%
Barclays Bank of Ghana Forex Bureau Ltd.	60.00%
Barclays Bank of Kenya Ltd.	68.50%
Barclays Advisory and Services Ltd.	68.50%
Barclays (Kenya) Nominees Ltd.	68.50%
Barclays Merchant Finance Ltd.	68.50%
Eagle Training Centre (Pty) Ltd.	74.86%
Spread Eagle Services Limited	68.50%
Barclays Bank of Serra Leone Ltd.	60.00%
Barclays Bank SA	99.44%
BARGES SA	99.44%
Ruval SA	99.44%

Subsidiary	Ownership Interest
Segunda Banlid de Inversion Immobiliaria SA (SEBANSA)	99.44%
Barclays Entidad De Financiacione, SA	99.44%
Serteban SL	99.44%
Barclays Correduria de Seguros SA	99.44%
Barclays Bank of Swaziland Ltd.	60.00%
Barclays Bank of Uganda Ltd.	51.00%
Barclays Bank of Uganda (Foreign Exchange Bureau) Ltd.	51.00%
Barclays Bank of New York, NA[1]	99.90%
Barclays Bank of Zimbabwe Ltd.	70.00%
Barclays Vie S.A.	99.99%
Barclays Zimbabwe Nominees (Pvt) Ltd.	70.00%
Barclaytrust (Pvt) Ltd.	70.00%
Claydon Holdings, Inc.	95.00%
Claydon Properties, Inc.	95.00%

[1] Barclays Bank of New York, N.A. has a number of 100 percent owned subsidiaries, not listed here.